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No. 98-2043

IN THE

Supreme Court of the United States

OCTOBER TERM, 1999

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Writ of Certiorari to the Court of Appeal of California For the First Appellate District

Brief Amicus Curiae of Multistate Tax Commission In Support of Respondent

Paull Mines
Counsel of Record
MULTISTATE TAX COMMISSION
444 No. Capitol Street, N.W.
Suite #425
Washington, D.C. 20001-1538
(202) 624-8682
Counsel for Respondent

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INTEREST OF AMICUS CURIAE[1]

The Multistate Tax Commission is the administrative agency formed by the Multistate Tax Compact. RIA ALL STATES TAX GUIDE ¶ 701 et seq., p. 751 (1995) ("COMPACT"). The COMPACT was developed cooperatively by States and taxpayers in response to the criticisms and recommendations of the Willis Committee. See David Brunori, *Interview: Gene Corrigan, A 'Proud Parent' of the MTC*, 17 ST. TAX NOTES 1295 (1999).[2] The COMPACT seeks to resolve issues inherent in "Our Federalism." Federalism recognizes separate and independent state taxing authority with regard to multijurisdictional commerce as a legitimate source of revenue for the several States to discharge their sphere of governmental responsibility.

Twenty-one States (including the District of Columbia) have adopted the COMPACT as a part of their law. One State is a sovereign member, a class of membership that affords a full consultative opportunity without formal adoption of the COMPACT. Nineteen additional States have expressed

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[1]No counsel for any party authored this brief in whole or in part, although the brief was submitted to a staff member of the California Franchise Tax Board who made comments that were considered in preparation of this brief. Only *Amicus* Multistate Tax Commission and its members States made any monetary contribution to the preparation or submission of this brief. Finally, this brief is filed pursuant to the consent of the parties.

[2]The Willis Committee, a congressional study of state taxation of interstate commerce sanctioned by TITLE II of PUB. L. NO. 86-272, 73 STAT. 555, 556 (1959), made extensive recommendations as to how Congress could regulate state taxation of interstate commerce.

commitment to the Commission by joining as associate member States.[3] This Court upheld the validity of the COMPACT in *United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978).

The Commission appears here to defend the qualified sovereignty of the States to tax interstate and foreign commerce that the Court has indicated should pay its fair share of the cost of state government. *Barclays Bank PLC* v. *Franchise Tax Bd.*, 512 U.S. 298 (1994); *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450 (1959). A defense appears necessary, because there is rapid expansion of multijurisdictional commerce in the United States and the rest of the world. This change has the potential to influence the operation of state tax systems and their compliance with the U.S. Constitution. The Commission's interest in this context extends to preserving existing state tax systems when allegations of extra-territorial taxation and Commerce Clause discrimination arising from multijurisdictional commerce are not supported by the jurisprudence of the Court.

Given the diversity of approaches used by the several States to match interest expense with taxed

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[3]The current full members are the States of Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Maine, Minnesota, Missouri, Michigan, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. The one sovereignty member is the State of Florida. The associate members are the States of Arizona, Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, West Virginia, and Wisconsin.

and non-taxed income, the Commission is specifically concerned with Hunt-Wesson's inherent suggestion to "constitutionalize" a particular method or methods as best suited to accomplish that task. The Commission's concern is increased here given the potential for an unclear constitutional pronouncement that would be based upon a record the parties are interpreting differently. The Commission seeks to avoid an unnecessary constitutional pronouncement on an "important federal question," U.S. Sup. Ct. R. 10(c), that would largely rest upon a taxpayer's allegations of "foot faults" by the state tax administrator. We believe the Court can conclude upon the entire record that it is unnecessary to find the existence of a constitutional infirmity here.

Further, the Commission is also concerned that this case may encourage a cascade of cases that would attempt to find violation of the Commerce Clause merely because a litigant can identify some geographical element in the challenged state taxing rule. This risk is especially troublesome when, as here, the geographical element is attributable to a State's good faith attempt to wrestle with constitutional requirements. Differences in state taxing rules that have a geographical element should not be overplayed as being constitutionally significant

Finally, the Commission seeks to avoid a Commerce Clause decision that would violate tax neutrality between in-state commerce and multijurisdictional commerce. Compare *Joseph* v. *Carter & Weeks Stevedoring Co.*, 330 U.S. 422 (1947), with *Dept. of Revenue* v. *Ass'n of Washington Stevedoring Cos.*, 435 U.S. 734 (1978) (eventual constitutional rule preserves neutrality). We think reasonable and protective Commerce Clause rules can be fashioned

without placing domestic commerce at a disadvantage. But see *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992).

SUMMARY OF ARGUMENT

The issues are simple. Does California's interest matching rule result in extra-territorial taxation. And does California's rule discriminate against [interstate and] foreign commerce. A further inherent question is whether the Constitution mandates any particular method of matching interest expenses with taxable and nontaxable income.

The issues arise because Hunt-Wesson erroneously insists that California first requires a total exclusion of nonbusiness interest expense before calculating the interest expense offset or reduction against nonbusiness dividend income. Hunt-Wesson also inappropriately contends that California has failed to meet a *State's* burden to prove that the excluded interest expense either was not related to business income or, alternatively, was related to nonbusiness dividend income. Examination of the entire record discloses that Hunt-Wesson has misinterpreted the evidence and has misapplied applicable constitutional doctrine.

California unequivocally states that the contested interest matching rule does not first require an exclusion of all nonbusiness interest expense. The tax form, Schedule R-5, relied upon by Hunt-Wesson to prove its case, was an error that has been corrected for this taxpayer and others. Further, Hunt-Wesson does not suggest it has been harmed by the erroneous tax form and its subsequent correction. After California's remedial action, there is little the Court could do to rectify this alleged constitutional misstep. See *Diffenderfer*

v. *Central Baptist Church of Miami, Florida*, 404 U.S. 412 (1972) (*per curiam*).

Similarly, the stipulations, a significant part of Hunt-Wesson's theory, fairly interpreted in light of the entire record, do not support the contention that the disallowed interest expense was attributable only to business income. Hunt-Wesson offers no other proof to this effect.

Hunt-Wesson's claim of indirect taxation of constitutionally exempt income, nonbusiness dividends, must fail, because the mechanical application of the matching rule in taxpayer's specific circumstance does not establish the matching rule's constitutional effect. California's matching rule does not offset against nonbusiness dividends unless the taxpayer has insufficient business interest income to swallow up the total interest expense without any regard to how the underlying indebtedness may have been used in the production of income. Also, the California rule does not require any reduction of the interest expense against nonbusiness dividend income, unless the taxpayer actually has such income. Therefore, under the California rule a taxpayer could have invested in nonbusiness assets without paying for those investments in the form of a reduction in the deduction of its interest expense.

Likewise there is no proof of taxation of extra-territorial income, because Hunt-Wesson (other than referring to stipulations that do not stand for their cited meaning) has not discharged its constitutional obligation to establish by clear and convincing evidence that the disallowed interest expense was related to extra-territorial income, the nonbusiness dividend income. In any event, Hunt-Wesson inappropriately seeks "to constitutionalize" the method States would have to employ to match

interest expense. This effort should be rebuffed, because there is no perfect method, all methods having their failures as is evidenced by the many diverse methods presently used by the States and the Federal Government to address this knotty problem. This kind of principle is better left to the legislative process in the absence of proof of systemic multiple taxation.

The matching rule does not violate the Commerce Clause. Hunt-Wesson did not rely on submitted evidence to support its premise that underlies this claim. By suggesting other "reasonable" matching methods, Hunt-Wesson admits debt capital is fungible and some portion of its interest expense was tied to the nonbusiness dividend income.

And there is no calculus available to establish that either domiciliaries were treated better or nondomiciliaries were treated worse. The matching rule applies without regard to the domicile of the taxpayer (no facial discrimination). The offset follows the character of the income received and not the residence of the taxpayer. Indeed, the California rule has the potential to treat nondomiciliaries quite favorably, better in some circumstances than the methods endorsed by Hunt-Wesson. And a domiciliary taxpayer faces a significant cost to securing more *deductibility* of its interest expense—full *taxability* of nonbusiness dividends. The absence of a calculus also follows from the uncertainty of ever knowing what one's tax attributes may be in the future. It would always remain a guess to change a domicile upon the desire to receive a *deduction* when the *tax* cost of having the deduction would necessarily remain unknown.

ARGUMENT

I. BEFORE EVALUATING THE CONSTITUTIONALITY OF CALIFORNIA'S RULE FOR MATCHING INTEREST EXPENSE TO DIVIDEND INCOME, THE COURT SHOULD REVIEW THE ENTIRETY OF THE RECORD TO UNDERSTAND HOW THE RULE OPERATES.

A. Introduction.

This is a simple case raising simple issues. Hunt-Wesson,[4] a non-domiciliary of California, challenges the constitutionality of the California rule for matching deductible interest expense against business and nonbusiness dividend income. Hunt-Wesson asks: (1) Does California's interest expense matching rule result in extra-territorial taxation. Pet. Brief 18-33. And (2) is California's interest expense matching rule discriminatory, because it is applied without tying the reduction in the interest expense deduction to constitutionally exempt dividends? Pet. Brief 35 (first para.). This case further asks if the Due Process and Commerce Clauses of the Constitution require a State to use any particular method or methods to match interest expenses to dividend income.

The need of a State to match interest expense is obvious. Hunt-Wesson does not dispute this self-evident principle. Pet. Brief 23. Without a matching rule for interest expense, a savvy taxpayer is encouraged to engage in interest arbitrage to avoid tax in a State that may only tax constitutionally apportionable dividend income.

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[4] We use the name Hunt-Wesson interchangeably with its predecessor-in-interest, Beatrice Foods Company.

To illustrate, Corporation is commercially domiciled in State A. Corporation earns $12 of apportionable income in State B. On advice of its tax professional, Corporation borrows $200 from a lender at 6 percent per annum interest for use in the business. Corporation simultaneously invests a "different" $200 in preferred stock with an annual dividend of 6 percent. The company issuing the preferred stock is totally unrelated to the unitary business being conducted in State B and the dividends are not therefore subject to tax by State B. Without an interest expense matching rule (whether by legislative choice or constitutional compulsion), State B will allow an interest deduction of $12 that completely eliminates the apportionable income of $12 in State B. Corporation has earned $12 of apportionable income in State B and yet has paid no tax on that income.

B. A Description Of The California Matching Rule For Interest Expense When Taxpayer Receives Constitutionally Exempt Dividend Income.

The issues arise because the U.S. Constitution constrains the taxing jurisdiction of a State with regard to a multijurisdictional company that receives dividends not tied to the unitary business operating within the taxing State (nonbusiness dividend income). UDITPA harmonizes its division of income rules with this reality. See Uniform Division of Income for Tax Purposes Act ("UDITPA") §1(a) (business income defined), 7A UNIFORM LAWS ANNOTATED 331, 336 (WEST 1985), also codified in California at Cal. Rev. & Tax. Code § 25120(a) and as a part of the COMPACT at Cal. Rev. & Tax. Code § 38006. And see UDITPA §1(e) (nonbusiness income defined), 7A UNIFORM LAWS ANNOTATED at 337, also codified as a part of California law at Cal. Rev. & Tax. Code § 25120(e) and as a part of the COMPACT at Cal. Rev. & Tax. Code § 38006. Business income is the state law (UDITPA) equivalent of income that may be subject to apportionment. Nonbusiness income is the state law (UDITPA) equivalent of income that may not be subject to apportionment. See *Allied-Signal, Inc.* v. *Director, Div. Of Taxation*, 504 U.S. 768,786 (1992); Pet. Brief 5-6.)

Jurisdiction to tax nonunitary dividends depends upon the company's commercial domicile. Under UDITPA, reflecting this jurisdictional understanding, all unitary or business income of a multijurisdictional business is apportionable regardless of domicile and all nonunitary or nonbusiness income is allocable, with nonunitary or nonbusiness dividend income specifically being allocated to the State of commercial domicile. See UDITPA §9, 7A UNIFORM LAWS ANNOTATED at 348, also codified in California at Cal. Rev. & Tax. Code § 25128 and as a part of the COMPACT at Cal. Rev. & Tax. Code § 38006; UDITPA §7 , 7A UNIFORM LAWS ANNOTATED at 346, also codified in California at Cal. Rev. & Tax. Code § 25126 and as a part of the COMPACT at Cal. Rev. & Tax. Code § 38006. The difference in the taxing jurisdiction of a State flowing from the character of the income being received, of course, necessitates matching interest expense to each class of income.

California's interest expense matching rule addresses this issue. It is hard to fathom how the Constitution would preclude the California rule based upon its intended purpose. We think Hunt-Wesson's characterization of the California interest expense matching rule as an effort to evade constitutional restrictions by circuitous means, Pet.

Brief 21, or a transparent attempt to tax exempt income, Pet. Brief 22, is unjustifiably inflammatory.

We understand the California matching rule to operate in three phases in the context of interest expenses and the receipt of nonbusiness dividend income. First, the multijurisdictional company is permitted, consistent with the fungibility of debt capital, to deduct the entirety of its interest expense to the extent of its business or apportionable interest income. Thus, the California rule allows a multijurisdictional company in practical terms to secure an interest deduction without any regard to how the company used the borrowing in its own mind. Second, again consistent with fungibility, the multijurisdictional company then offsets the remaining interest expense deduction to the extent of the nonbusiness interest and dividend income. Finally, whatever interest expense deduction remains is then allowed against any other apportionable income. The statute applies regardless of whether the multijurisdictional company is a domiciliary or non-domiciliary of California.

The above description does not note the additional adjustment that pertains to dividends declared by companies from previously taxed California income. This adjustment was not applied in here, although the availability of the adjustment does form an alternative basis of Hunt-Wesson's Commerce Clause complaint. Pet. Brief 38ff. This special circumstance may be analyzed separately. We leave to others whether the circumstance has been properly raised before the Court or affords any basis for the claim of discrimination.

C. <u>An Analysis Of The Record Reveals Hunt-Wesson's Argument Of Unconstitutionality Is Based Upon An Erroneous Premise</u>.

Of course, the foregoing description of the operation of the California interest expense matching rule differs from Hunt-Wesson's representations. The differences and the alleged constitutional infirmity that arises therefrom are

1. Hunt-Wesson believes that a multijurisdictional company must first eliminate all nonbusiness interest expense (interest expense related to the production of nonunitary or nonbusiness dividend income) before calculating any reduction (or offset) in the interest expense deduction. Hunt-Wesson contends only business interest expense (interest expense related to unitary or business dividend income) is subject to the reduction.

2. From the understanding described in the preceding paragraph, Hunt-Wesson submits that California on a dollar for dollar basis arbitrarily denies non-domiciliaries a deduction for business interest expense. Extra-territorial taxation results. Hunt-Wesson asserts domiciliaries do not face this same reduction in their business interest expense deduction. Unconstitutional discrimination also results.

3. To supplement the argument of the preceding paragraph, Hunt-Wesson also states that California never tries to tie any part of what Hunt-Wesson calls the "net business interest expense" to either apportionable dividends or nonbusiness dividends. (The phrase is "'*net*' business interest expense," because Hunt-

> Wesson acknowledges a non-domiciliary may deduct business interest against business interest income. Pet. Brief 8-9.

Hunt-Wesson's argument is totally premised on a restrictive and unrealistic view of the record in this case.

1. The California Matching Rule Does Not First Exclude All Nonbusiness Interest Expense Of A Non-Domiciliary Before Calculating The Interest Expense Deduction.

The parties' disagreement over the operation of the matching rule is reminiscent of an earlier case where the parties disagreed over an issue central to the proper resolution of the case. *Franchise Tax Bd.* v. *Alcan Aluminium Ltd.*, 493 U.S. 331, 339-41 (1990) (ruling on applicability of Tax Injunction Act will not be based upon speculation). The settled jurisprudence of the Court permits proper disposition of this case. When it comes to the important matter of determining the federal constitutional limits of state taxation, an essential aspect of state sovereignty, *Dows* v. *City of Chicago*, 11 Wall. 108, 110 (1871), this Court will examine the entire record to reach its own independent judgment on whether constitutional rights are invaded. *Container Corp. of America* v. *Franchise Tax Bd.*, 463 U.S. 159, 176 (1983), quoting *Norton Co.* v. *Dept. of Revenue*, 340 U.S. 534, 538 (1951).

As to whether California's matching rule first excludes nonbusiness expenses, (Pet. Brief 8-9; Resp. Brief 24-25], we accept the Franchise Tax Board's representations as made in good faith. We know of no reported authority suggesting otherwise, except for the since revised state tax form, Schedule R-5 of Form 100, that was plainly inconsistent with

the governing statute, Cal. Rev. & Tax Code §24344(b). The audit is also consistent with the Board's representations. Ex. 3 to Stip. 12 (C.T. 93) (audit workpaper lacks any such exclusion).

Further, even if Hunt-Wesson's view of the first step is accepted, the first step did not result in any allocation to the claimed category of "nonbusiness interest expense." Pet. Brief 10 (all of the total interest expense was business interest expense). And in the context of the entire record of this case, the lack of any "Step 1" allocation of the disputed interest deduction to nonbusiness interest expense does not reflect a *valid* determination that the entirety of Hunt-Wesson's disputed interest expense was in fact a business interest expense.

Hunt-Wesson undoubtedly took its return position that all of its interest expense was business interest expense to support its legal position that all of its expense should be deductible. But it appears Hunt-Wesson's return position was developed from an erroneous legal standard. Pet. Brief 5 ("[a]ccordingly" Hunt-Wesson's deduction taken because none of the debt capital went to any of the nonunitary affiliates). The crucial point is that the absence of showing direct investment of the debt capital in the operations of the nonunitary affiliates does not negate the possible use of this capital to produce the constitutionally exempt dividend income. The debt capital may have freed other capital for use in the operations of the nonunitary ventures or have been used to finance the carrying of the ownership interest itself in these ventures. See pp. 17-18, below.

Additionally, Hunt-Wesson's endorsement of other "reasonable" or "fair" methods of allocation, like the asset (cost or value) or gross income ratio

methods, clearly acknowledges some portion of the disputed interest expense is properly attributed to the nonbusiness dividend income. Pet. Brief 25-26 (other fair methods exist; reasonable allocation of interest expenses would obviate the constitutional issues raised by this case); 28 (different allocations methods adopted by other States are fair); 30ff. (Federal Government's methods similarly fair).

Hunt-Wesson's assertion that it first had to exclude all nonbusiness interest expense had no impact on the calculation of the limitation of the interest expense deduction as a matter of fact or of constitutional interpretation. The parties' disagreement reflects nothing more than Hunt-Wesson's seizing upon a since corrected administrative misstep.

Further, we do not view the stipulation 11 (J.A. 20), heavily relied upon by Hunt-Wesson, in the same light. Hunt-Wesson argues stipulation 11 means only the business interest expense portion of a non-domiciliary's interest expense deduction is potentially subject to being offset against constitutionally exempt income. Pet. Brief 8-9, 24-25.

Based upon its belief that all nonbusiness interest expenses are first eliminated from the offset calculus, Hunt-Wesson describes the portion of a non-domiciliary's interest expense deduction that is actually set off against constitutionally exempt income as "Net Business Interest Expense." Pet. Brief 9. Hunt-Wesson persistently uses this phrase or concept to color the California rule. *E.g.*, Pet. Brief 10 ("all of which was business interest expense"); Pet. Brief 23 ("net business interest expense must be reduced"); Pet. Brief 24 n.18 ("it is 'net' business interest . . . that remains"); Pet. Brief 24 n.19 (statute limits net business interest expense); Pet. Brief 24 ("just an arbitrary assignment,

on a dollar-for-dollar basis, of business interest expense"); Pet. Brief 25 (nonbusiness interest expense eliminated prior to calculating the offset).

However, Hunt-Wesson's interpretation of stipulation 11 misses the mark. Apart from the characterization not reflecting the governing statute, Cal. Rev. & Tax Code §24344(b), the stipulation fairly interpreted in light of the other stipulations describes nothing more than the return position of taxpayer, specifically its completion of Schedule R-5. This limited understanding of the stipulation is supported by the next immediate stipulation, no. 12 (J.A. 20) and Ex. 3 to no. 12 (C.T. 93), that describes the audit adjustment of the taxpayer's return that is the subject of stipulation 11. Tellingly, the audit report calculates the interest offset, Ex. 3, without any step for eliminating nonbusiness interest expense. Therefore, if the Court accepts the Franchise Tax Board's characterization of Schedule R-5 (Resp. Brief 24-25), stipulation 11 describes nothing more than the Hunt-Wesson's tax reporting position on an erroneous form. California then corrected Hunt-Wesson without regard to any of the instructions on Schedule R-5.

Regardless of these observations, the Court has little to rely upon to issue a constitutional pronouncement on an allegedly "important federal question" in the face of California's representation to the Court that it does not administer Cal. Rev. & Tax Code §24344(b) in the manner alleged by Hunt-Wesson. Resp. Brief 24-25. This matter clearly is not a case where the State is engaging in sleight of hand to avoid a constitutional determination. Hunt-Wesson outlines no prejudice from California's correction. If Hunt-Wesson's case collapses from California's remedial action, that is the way it

should be. California's express statement of how it administers the statute alleged to offend the Constitution is constitutional protection enough. Nothing would be gained from a declaration by the Court that would hold this kind of rule to be constitutionally invalid, if that were the kind of ruling the Court would otherwise make. See *Diffenderfer* v. *Central Baptist Church of Miami, Florida*, 404 U.S. 412 (1972) (*per curiam*).

2. The Record Fails To Support The Assertion That The Borrowings Giving Rise To The Disputed Interest Expense Deduction Lack Any Relationship With The Nonbusiness Dividend Income.

Surprisingly, Hunt-Wesson relies heavily upon stipulation 9 as establishing that none of its borrowings can be tied to the nonbusiness dividend income. Stipulation 9 (J.A. 19) states:

> For the fiscal years at issue, [Hunt-Wesson] did not make direct operating loans to its foreign subsidiaries. Each foreign subsidiary was directly responsible for its own borrowings.

Using stipulation 9, Hunt-Wesson asserts that all of its interest expense is necessarily deductible. Pet. Brief 5 (because of the facts of stipulation 9 an interest expense deduction was "[a]ccordingly" claimed). This was also the view of the Superior Court that ruled in favor of Hunt-Wesson. Pet. Brief 13 (quoting the Superior Court, facts of stipulation 9 make it appear that none of interest expense can be attributed to the exempt income). With this predicate, Hunt-Wesson concludes that the facts do not support finding any relationship between the borrowings generating the interest expense deduction and the nonbusiness dividend income. Pet. Brief 16 (facts do not reveal); Pet. Brief 20 (citing the Superior Court's interpretation of stipulation 9 as authority, Pet. Brief 20 n.14, interest expense did not bear any direct relationship to the nonbusiness dividend income).

Consistent with its view of stipulation 9, Hunt-Wesson also introduces its appeal with the generalized conclusion that the denial of the interest expense deduction occurs even when the deduction bears no relationship to the nonbusiness dividend income. Pet. Brief 2.

But Hunt-Wesson errs in its expansive interpretation of stipulation 9. Stipulation 9 only refers to making direct operating loans to its nonunitary affiliates. It does not negate the borrowings generating the interest expense deduction might have been used to acquire or carry assets that produced the nonbusiness dividend income. Surely, Hunt-Wesson does not dispute that the interest expense of borrowings used to acquire or carry assets that are producing the exempt income is also properly matched against that exempt income. Cf. Section 265, Internal Revenue Code of 1986.

Further, stipulation 9 does not address the issue of whether Hunt-Wesson had a choice to determine which business operation would raise debt capital and which operation would employ already available capital. As the interest arbitrage illustration demonstrates, p. 8, above, if Hunt-Wesson wanted to minimize its California tax exposure, it would have been well-advised to have the unitary business operations do the borrowing and then argue for the unconstitutionality of the California matching rule.

Stipulation 9 does not establish that the total interest expense at issue either was tied to the

production of business or apportionable income or lacked any relationship with the nonbusiness dividend income. Stipulation 9 only states that the pertinent borrowings were not directly used in the production of the income *within the corporate solution* of the nonunitary affiliates. The record does not negate finding some of the interest expense as attributable to the production of nonbusiness dividend income. Hunt-Wesson has endorsed as fair or reasonable other methods of matching interest expense that would undoubtedly attribute interest to its nonbusiness dividends and thereby admits as much. Pet. Brief 28-33.

3. The Matching Rule's Reduction Of A Non-Domiciliary's Interest Expense Deduction Does Not Tax Indirectly Nonbusiness Dividend Income.

Hunt-Wesson also relies heavily on stipulation 14 (J.A. 21) to claim that its net business interest expense deduction was disallowed solely because it received nonbusiness dividends. Stipulation 14 in pertinent part states:

> The disallowance of [Hunt-Wesson's] interest expense was due entirely to the receipt by [Hunt-Wesson] of dividends from its nonunitary subsidiaries . . . .

Hunt-Wesson joins stipulation 14 with stipulation 9 (J.A. 19) to emphasize its view that disallowance of the interest expense deduction is totally attributable to the offset against the nonbusiness dividend income and that this gives rise to indirect taxation of constitutionally exempt income. Pet. Brief 11 (deduction denied because taxpayer received constitutionally exempt income; Board

made no determination that interest was related to constitutionally exempt income); Pet. Brief 16 (denying interest expense deduction without establishing relationship with exempt income results in taxation of that income); Pet. Brief 19 (only reason for disallowance is receipt of constitutionally exempt income because relationship of the interest expense to that income is irrelevant); Pet. Brief 20 (increase in taxable income attributable entirely to exempt income); Pet. Brief 20 n.15 (to same effect).

But Hunt-Wesson is confusing stipulation 14, a description of the mechanics of the matching rule in this particular and unique case, with the constitutional interpretation of the effects of the rule. Thus, under the California rule there is only a *potential* interest expense reduction against nonbusiness dividend income, if the non-domiciliary actually has such income. The only way for the non-domiciliary receiving nonbusiness dividends to lose some of the interest expense deduction is for the taxpayer to have (fungible) debt capital and nonbusiness dividend income. In this sense, we suppose one could describe the operation of the matching rule as dependent upon the receipt of constitutionally exempt dividend income. But we are puzzled as to what that establishes in a constitutional sense.

It is quite possible under the California matching rule that a non-domiciliary with fungible debt capital and nonbusiness dividend income may never experience any reduction of its interest expense deduction. This could occur when the non-domiciliary has enough business or apportionable interest income to swallow up the interest expense deduction without ever getting to the potential reduction against the nonbusiness dividend income. California

does allow a total deduction of a taxpayer's interest expense against business or apportionable interest income without regard to how the borrowing may have been used. Cal. Rev. & Tax Code §24344(b). Hunt-Wesson apparently did not have enough business or apportionable interest income to take full advantage of California's generous rule. Further, a non-domiciliary with fungible debt capital and nonbusiness assets may have no nonbusiness dividend income at all. Here again, the rule results in no reduction of the interest expense deduction.

In the end, we submit the peculiar and unique circumstances of Hunt-Wesson cannot form a proper description of the California rule as one that always states any interest expense deduction of a non-domiciliary will be reduced dollar for dollar by the nonbusiness dividend income. Hunt-Wesson has not established "indirect taxation" of constitutionally exempt income.

II. HUNT-WESSON HAS NOT ESTABLISHED THAT CALIFORNIA'S MATCHING RULE FOR INTEREST EXPENSE RESULTS IN UNCONSTITUTIONAL STATE TAXATION OF EXTRA-TERRITORIAL INCOME.

We read Hunt-Wesson's first argument, Pet. Brief 18-33, as contending that California is unconstitutionally taxing extra-territorial income. Although the argument is stated in terms of taxing income California is forbidden to tax under the Constitution, *e.g.*, Pet. Brief 16, it is still is an allegation of extra-territorial taxation. See *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980); *Allied-Signal, Inc.* v. *Director, Div. Of Taxation*, 504 U.S. 768 (1992). But this argument lacks its premise, ignores well-established constitutional doctrine on taxpayer

burden of proof, and amounts to no more than an expressed preference for other tax administrative methods to manage the fungibility of debt capital that this particular taxpayer views as fairer and more reasonable.

A. The Premise Of Hunt-Wesson's Argument Does Not Exist.

In order to carry its argument, Hunt-Wesson represents that California reduces the interest expense deduction only because it received tax exempt dividends without any effort to determine whether the interest expense related to the production of that income. Yet as noted previously with regard to stipulations 9, 11 and 14 (J.A. 19, 20, 21), Hunt-Wesson has bootstrapped an argument that simply does not reflect either the entire record or the actual operation of the California matching rule. See pp. 12-20, above. And Hunt-Wesson gives scant attention to the favorable step of the California matching rule that is based upon the fungibility of debt capital, that is, the allowance of the interest expense deduction on a dollar-for-dollar basis to the full extent of business interest income. Recognition of the reality of fungibility applies both ways for Hunt-Wesson.

B. Hunt-Wesson Has Not Satisfied Its Burden Of Establishing The Existence Of State Taxation Of Extra-Territorial Income.

The California matching rule does not require a reduction of interest expense without regard to the relationship of the deduction to either business dividend income or to nonbusiness or exempt dividend income. See pp. 16-18. Further, we do not agree with Hunt-Wesson that the law ensures that the denial of the deduction will only concern interest

expense that is in fact tied to business dividend income. See pp. 12-16, above. Rather, the California matching rule should be viewed as one of the several different methods that tax administrators use to reflect the undeniable reality that debt capital is fungible. We do not understand Hunt-Wesson to take any issue with the fungibility of debt capital. Pet. Brief 25-26. Given this reality, it is fitting to describe the entirety of the California matching rule as solely concerned with matching the interest expense deduction with the benefiting dividend income.

There is after all no reasonable way to isolate out how a borrowing is being used in fact. Even if the proceeds of a borrowing are traced to being used in a particular fashion, that tracing does not rule out that the borrowing actually permitted the taxpayer to carry some other asset or group of assets rather than to sell them. Similarly, pledging an asset or group of assets does not disclose what part of the business is actually benefiting from the borrowing, since management may have determined that the pledged assets represent the least burdensome collateral without regard to how the debt capital actually was to be used.

But we do not think that these observations would preclude any taxpayer from proving in a rare case that its borrowing and its related interest expense could in fact, due to peculiar factors, be attributed to one type of dividend income. We would not suppose any taxpayer believing that the facts of its circumstance resulted in an unconstitutional assessment of a tax would not be afforded the opportunity to prove those facts.

But Hunt-Wesson does not contend that it was denied any opportunity to prove its borrowings were related to business income. Instead, Hunt-Wesson

resorts to praising the virtues of other methods of interest matching that also operate on the premise of fungibility. Hunt-Wesson's apparent failure to take on the issue of proof of a relationship of the borrowings to apportionable income may well therefore reflect Hunt-Wesson's own realistic acknowledgement that it could not prove this tie. Yet, retreating into silence in the face of the impossibility of proof in a constitutional dispute involving the sensitive issue of the division of income of a multijurisdictional business does not carry the day.

It is a well established principle of constitutional interpretation of the limits of state taxing jurisdiction that the taxpayer bears the burden of establishing the existence of extra-territorial income. *Container Corp. of America* v. *Franchise Tax Bd.*, 463 U.S. 159, 164 (1983) (taxpayer has the burden of showing by "clear and convincing evidence" that state is taxing extraterritorial values); *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 271-275 (1978) (taxpayer failed in its proof). The rule is further buttressed by the time-honored observation that it is the taxpayer that must show an arbitrary or unreasonable result. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 120-21 (1920). Hunt-Wesson, other than retreating into an argumentative position on the meaning of stipulations and the operation of the California matching rule presents no basis in law or the record, to meet its burden.

C. Hunt-Wesson Expresses No More Than A Personal Preference For Other Methods Of Matching An Interest Expense Deduction To Dividend Income.

Putting aside our disagreement with Hunt-Wesson on the existence of unconstitutional extra-territorial taxation, we find the expressed preference for other methods of interest expense matching, Pet. Brief 26-32, both instructive and frustrating.

Enlightenment comes from the necessary corollary to this endorsement. Hunt-Wesson must believe some portion of its interest expense deduction is appropriately tied to its nonbusiness dividend income. This follows because these other fair and reasonable methods will presumably result in some of Hunt-Wesson's interest expense deduction being attributed to Hunt-Wesson's nonbusiness dividends.

In the end the dispute is over California's method that Hunt-Wesson describes without proof as arbitrary. Pet. Brief 24. In describing this arbitrariness, Hunt-Wesson totally ignores that aspect of the California interest expense matching rule that first allows the taxpayer a total deduction of the interest expense to the extent of business interest income. Hunt-Wesson while acknowledging this portion of the rule in its initial description, Pet. Brief 8-9, never discusses how this provision impacts the fairness of the California rule. The avoidance of this aspect of the California matching rule suggests Hunt-Wesson might face some disagreement over the fairness of the California rule with a nondomiciliary company that has sufficient business interest income to absorb the totality its interest expense deduction.

And the alleged fairness of the methods endorsed by Hunt-Wesson is not readily apparent. Consider interest expense matching by property ratios that Hunt-Wesson describes. Under the asset ratio approach, it is possible a non-domiciliary might face a reduction of its interest expense deduction in situations where the California matching rule would not significantly reduce the expense because the taxpayer had no substantial nonbusiness dividend income.

Some may argue against the fairness of an asset ratio on the basis that the underlying borrowing was secured due to the borrower's ability to generate cash flow and income and not asset value. Also, fairness, including its cousin administrability, comes into play when one realizes a choice must be made between current values and historic costs under the asset ratio approach. And which is fairer, a determination of value of the nonunitary affiliate by outside (*e.g.*, stock) fair market value or acquisition cost or by inside (*i.e.*, assets held in corporate solution) fair market value or acquisition costs?

Similar issues exist with respect to using income ratios. But the point here is not which method of interest expense matching is the best. The diversity of approaches used in matching interest expense itself, documented by Hunt-Wesson, Pet. Brief 28-33, suggests that determining fairness in any absolute sense would be futile. Rather these preliminary observations demonstrate, as the Court recognized in *Moorman*, 437 U.S. at 277-280, that in the absence of the taxpayer's actual proof of unfairness, including the presence of systematic multiple taxation, it would be inappropriate to establish through extensive judicial lawmaking a *constitutional* standard for income division. This

kind of matter, matching interest expense, is better left to the Congress and/or state legislatures.

III. CALIFORNIA'S INTEREST EXPENSE, MATCHING RULE DOES NOT VIOLATE THE COMMERCE CLAUSE.

A. Hunt-Wesson's Underlying Rationale For Finding Discrimination Is Not Supported By The Record.

Hunt-Wesson acknowledges California's interest expense matching rule would not be discriminatory, if the rule reflected nothing more than the constitutional limitation on California's taxing power over non-domiciliary companies. Pet. Brief 34. There is nothing surprising in this concession. Inevitably, one must conclude a determination of discrimination is not supported by showing a domiciliary company will always have more interest expense available to it in the domiciliary State than a non-domiciliary. Greater deductibility in the domiciliary State follows, because the domiciliary is subject to tax on its nonbusiness dividend income and this income will attract some portion of the deduction of interest expenses.

But Hunt-Wesson states this reality is not applicable here, because the disallowed interest expenses cannot be viewed as relating to the constitutionally exempt dividend income. Pet. Brief 35. Therefore, in Hunt-Wesson's view the disallowance is necessarily based upon the domicile of the taxpayer and not the character of the income received.

Hunt-Wesson's Commerce Clause argument is quite similar to its claim that the California matching rule results in taxation of extra-territorial income. As a part of this claim, Hunt-Wesson asserted in essence that without proof of the relationship of

the disallowed interest expense to nonbusiness dividend income, California must be treated as taxing extra-territorial income. We will not repeat our analysis of the claim of extra-territorial taxation that demonstrated Hunt-Wesson lacks the support of the record and disregards applicable constitutional principle. See p. 21 that references pp. 12-20.

We note, however, that while Hunt-Wesson rejects the California matching rule as a reasonable convention for establishing the relationship between the disallowed interest and nonbusiness dividend income, it endorses other "fair" and "reasonable" methods that utilize fungibility of debt capital to make an apparently valid determination of the necessary relationship. But Hunt-Wesson's endorsement is not based upon any empirical proof that the elements used in its "approved" methods are any better suited to be the surrogates for attributing interest expense to the appropriate class of income than the elements of interest and dividend income used in the California rule. This expected gap in proof reflects that any of the conventions could be attacked in some of the possible circumstances that give rise to the need to accomplish the matching. *E.g.*, pp. 24-25, above. The existence of so many variants itself suggests the self-evident observation that in reality there is no single correct answer to choosing the perfect approximation for matching interest expense to the classes of dividend income.

B. In Any Event, Hunt-Wesson Has Not Proved The California Interest Matching Rule Favors Domiciliaries Over Non-Domiciliaries.

Hunt-Wesson's viewpoint taken at face value does not support a determination of Commerce Clause discrimination. There can be no determi-

nation of discrimination, because no calculus demonstrates that non-domiciliaries generally face a higher tax burden under the California interest expense matching rule.

Certainly, facial discrimination is not present, because domiciliaries and non-domiciliaries face the exact same rule. It is the character of the income received that determines the availability of an interest expense deduction. There is nothing in the rule itself that discloses tax differentiation based upon domicile.

For another, discrimination in operation cannot be established by claiming non-domiciliaries generally are worse off under the rule. As previously noted all of the matching rules have their good and bad points as clearly demonstrated by circumstances where the California rule might be better for non-domiciliaries than the other "rational" rules Hunt-Wesson views as reasonable. *E.g.*, pp. 19-20, 24-25. What Hunt-Wesson has done is to assert unconstitutionality based upon its own unique factual circumstances and then to claim the other methods that are more generous to it than the California matching rule are constitutional. Yet the Commerce Clause protects the integrity of the interstate and international markets, not particular firms. See *Exxon Corp.* v. *Governor of Maryland*, 437 U.S. 117, 127-28 (1978).

Finally, the calculus of discrimination cannot be completed in any event, because the availability of a *deduction* dependent upon domicile is not the only aspect of the California franchise tax system that must be examined to determine *tax* cost. What Hunt-Wesson describes as the more favored position of a domiciliary company carries the uncertain cost of total taxability of nonbusiness dividend income

based upon the presence of the taxpayer's commercial domicile. This added cost occurs within a single integrated tax, the California franchise tax based upon net income, and arises out of the need to match expenses with two classes of dividend income. In these circumstances we do not understand that the restrictions against using the compensatory tax doctrine would apply at all. Cf. *Washington* v. *United States*, 460 U.S. 536, 542-43 (1983) (discrimination established by an examination of the whole tax structure of the State); *Fulton Corp.* v. *Faulkner*, 516 U.S. 325 (1996).

No one can claim in this situation that there would be any incentive for a non-domiciliary taxpayer to be treated like a domiciliary so that it could use a greater proportion of its interest expense deduction. After all, the total tax could vary considerably each year depending upon the taxpayer's specific, but uncertain, tax attributes. Thus, the total amounts of interest expense, business or apportionable income, apportionable interest and dividend income, and nonbusiness dividend income will be uncertain as to the future, to say nothing of other attributes.

But inability to calculate any discrimination cost as described above would not allow a State to deny any interest expense deduction related to business or apportionable income to non-domiciliaries, while granting it to domiciliaries. In this latter case, which Hunt-Wesson attempts to paint as its circumstance by contending that the California rule requires the total exclusion of nonbusiness interest expense from the calculation of the offset, *e.g.*, Pet. Brief 8-9, the taxing State offers no possibility of any benefit from deducting interest expenses related to business or apportionable income to a non-domiciliary while

affording that opportunity to the domiciliary. That kind of treatment would be discriminatory. But here the California rule preserves a realistic opportunity under various circumstances that the non-domiciliary will secure benefit from its interest expense, and in some cases on a very favorable basis. *E.g.*, taxpayer's business interest income is sufficient to cover the total interest expense, even though taxpayer holds nonbusiness assets paying nonbusiness dividend income.

CONCLUSION

In its simplest terms, the taxpayer seeks this Court's mandate to establish a constitutional rule for how States should match deductible interest expense to taxable and nontaxable income. Adoption of this rule would depart from settled principles governing the sensitive issue of state taxation in our federal system and would place the Court into the quagmire of extensive judicial law making. The Court should affirm the decision below with a mandate that Hunt-Wesson's claim be dismissed.

RESPECTFULLY SUBMITTED,

Paull Mines
Counsel of Record
MULTISTATE TAX COMMISSION
444 No. Capitol Street, N.W., #425
Washington, D.C. 20001
(202) 624-8682

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